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Supreme Court of the United States

OCTOBER TERM, 1948.

No. 731

HUGH SMITH, INC., PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioner prays that a writ of certiorari issue to review the order of judgment of the United States Court of Appeals for the Sixth Circuit in this cause, which was entered (without opinion) on February 1, 1949, and which affirmed the decision of The Tax Court of the United States, entered on June 25, 1947.

OPINION BELOW.

The Court of Appeals did not file an opinion. The findings of fact and opinion of the Tax Court are reported in 8 T. C. 660.

BASIS OF JURISDICTION.

Jurisdiction is invoked under Title 28, United States Code, Section 1254(1).

QUESTIONS PRESENTED.

I.

Does Section 45 of the Internal Revenue Code (the purpose of which was "to prevent evasion of taxes or clearly to reflect the income") authorize the Commissioner to "allocate" to petitioner, or to any taxpayer, income which it is known never to have earned or received, and when it is known that no taxes were "evaded" by anyone as the result of the formation or existence of the petitioner?

II.

If the petitioner had in fact earned or received income from the purchase and re-sale of Coca-Cola syrup (which for the years prior to 1941 it is known that it did not), would such income have been personal holding company income, as defined in Section 502 of the Internal Revenue Code?

SUMMARY STATEMENT OF THE FACTS.

Hugh Smith, an individual, owned and operated Coca-Cola bottling plants at Union City, Tennessee, and at four other near-by towns. He purchased all his Coca-Cola syrup from Coca-Cola Bottling Works (Thomas), Inc., of Chattanooga, Tennessee.

In the summer of 1931 Mr. Smith was advised that the legal department of the Coca-Cola Company considered the contract under which he was buying his syrup and operating each of his bottling plants as "individual" to him; and that, since it was not made to any "heirs or assigns," it would come to an end at his death. And it was suggested to Mr. Smith, by a representative of Thomas, Inc., that "in order to perpetuate the contract he form a corporation"—which he did (R. 77). He then surrendered his individual contract to Thomas, Inc., who re-issued it to the new corporation, Hugh Smith, Inc., the petitioner here; and the corporation issued its sub-bottler's contract to Mr. Smith—who continued on in the operation of his bottling companies, just as he had before the formation of the petitioner corporation. And he, individually, bought all the Coca-Cola syrup he used from Thomas, Inc., and at exactly the same price he had been paying before the formation of the corporation. And the syrup was all shipped to him, and billed to him, and paid for by him; all in exactly the same manner as before the corporation was formed (R. 78).

The petitioner, Hugh Smith, Inc., never bought or sold a single gallon of Coca-Cola syrup, or anything during the lifetime of Hugh Smith, the individual (R. 78, 88). It had no operations. There was never any intention that it would operate (R. 59). The sole object in forming the corporation was to "hold the franchise" so that it might be perpetuated indefinitely and afford Mr. Smith the power to give his heirs and beneficiaries the benefit of it (R. 59).

For the years 1931 to 1940, inclusive, the petitioner had no earnings. It paid, and could have paid, no dividends. It had no undistributed surplus. It simply did not operate; but served only to hold the contract with the Coca-Cola Company.

But for each of the years 1934 to 1937, inclusive, the Commissioner "allocated" to the petitioner a net income equal to 20 cents on each gallon of Coca-Cola syrup *purchased and used by Mr. Smith.* That is the amount of gross profit it could have earned if it had operated under its contracts by which it could have purchased syrup from Thomas, Inc., at $1.30 a gallon and could have sold it to Mr. Smith for $1.50 a gallon. That, of course, would have reduced Mr. Smith's taxable income by 20 cents a gallon. Instead of doing this, Mr. Smith simply purchased the syrup from Thomas, Inc.—for $1.30 a gallon.

After "allocating" this mythical, non-existent, income to the petitioner (under his asserted authority in Section 45 of the Internal Revenue Code), the Commissioner held that such income (if it had been earned) would have been personal holding company income, and that, since all of petitioner's stock was owned by only five individuals, such income was subject to the surtax on personal holding companies, provided by Section 500 of the Code.

The Commissioner did not reduce Mr. Smith's individual income by the amount he "allocated" to the petitioner—or by any amount. Although he stated in his notice of deficiency that he had allowed such deductions to "Hugh C. Smith prior to his death, and his estate thereafter" (R. 10), it was proved that it was not allowed and that this "is not a true statement" (R. 98). He did not assert or contend that any taxes had been evaded by Mr. Smith, or by anyone, as a result of the organization or existence of the petitioner.

After Mr. Smith's death (which occurred on August 25, 1940) and beginning with January 1, 1941, there *was* credited to the petitioner 20 cents on each gallon of Coca-Cola syrup used by the bottling plants—then owned by his estate. This income was reported by the petitioner for the year 1941 and for 1942, up to the date of its dissolution, on May 31, 1942; and it paid corporation income tax and excess profits tax on such income. However, the Commissioner held that such income so reported was subject to *personal holding company surtax*—and he assessed same, together with interest.

The net results of all this are summarized in the statements below:

Totals of Income, and of Tax and Interest Paid Thereon, from 1937 to 1940—the Period Before Mr. Smith's Death.

1937 to 1940

Income "Allocated" to Hugh Smith, Inc. (R. 35)	$ 58,679.64
Tax Paid by the Former Stockholders of Hugh Smith, Inc., on This $58,679.64 of "Income" (R. 52)	$ 60,877.51
Add: Interest Assessed (and Paid) on This Tax	$ 28,895.85
Total Tax and Interest Paid by the Former Stockholders on This $58,679.64 of "Income," Never Received	$ 89,773.36
Add: Amount of Tax Already Paid by Hugh Smith, the Individual, on This Same Income	$ 24,919.89
Total Tax and Interest Paid on This $58,679.64 of Income	$114,693.25

Totals of Income, and of Tax and Interest Paid Thereon, from 1941 and 1942—the Period After Mr. Smith's Death.

1941 and 1942

Amount of Income Earned, Received and Reported (not "Allocated") by Hugh Smith, Inc., for 1941 and 1942, at 20¢ per Gal. (R. 35)	$ 26,906.47
Income and Excess-profits Tax Paid by Hugh Smith, Inc., on Its Returns As Filed (R. 22, 23)	$ 10,547.34
Add: Personal Holding Co. Tax, Additional Income Tax, etc., Assessed Against Hugh Smith, Inc. (and Paid by Its Former Stockholders) (R. 22, 23)	$ 23,361.60
Total Tax Assessed (and Paid) on This $26,-906.47	$ 33,908.84
Add: Interest Assessed (and Paid) on This Additional Tax	$ 7,839.21
Total Tax and Interest Paid on This $26,906.47	$ 41,748.15

Totals of Income, and of Tax and Interest Paid Thereon, from 1937 to 1942.

1937 to 1942

Income "Allocated" to Hugh Smith, Inc. (R. 35)	$ 85,586.11
Tax Paid by the Former Stockholders of Hugh Smith, Inc., on This $85,586.11 of "Income" Never Received (R. 52)	$ 84,239.11
Add: Interest Assessed (and Paid) on This Tax	$ 36,735.06
Total Tax and Interest Paid on This $85,586.11 of "Income" (R. 35) Never Received	$120,974.17

Add: Amount of Tax Already Paid by Petitioner on $26,906.47 of This Same Income for 1941-1942	$ 10,547.34
Amount of Tax Already Paid by Hugh Smith, the Individual, on $58,679.64 of This Same Income for 1937 to 1940	$ 24,919.89
Total Tax and Interest Paid on This $85,586.11 of "Income" So "Allocated"	$156,441.40

REASONS FOR GRANTING THE PETITION.

I.

The United States Court of Appeals for the Sixth Circuit has, decided (or has, by entering its order, without opinion, refused to decide) two important questions of Federal income tax law, which have not been but should be settled by the Supreme Court.

Section 45 of the Internal Revenue Code is an important statute in the law of Federal income taxation. It gives the Commissioner wide discretion to "allocate" income; *but* only when such "allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income."

Does it give him authority to "allocate" when there *has been no evasion?* or when the *income is clearly reflected;* and when it has been reported, and tax has been paid on all of it?

Does it give him authority to "allocate" income (as he has done in this case) for the sole purpose of collecting more tax? Does it give him authority to collect $119,706.34 in tax on $85,586.11 of income? And $36,735.06 in interest on the tax asserted and assessed on non-existent income? That was not the purpose of Section 45.

The *Report of the Committee on Finance* (Sen. Rept. No. 960, 70th Cong., 1st Sess., p. 24) and the *Report of the Committee on Ways and Means* (H. R. Rept. No. 2, 70th Cong., 1st Sess., p. 16) which accompanied the Revenue Bill of 1928 contained the following statement:

> "Section 45 is based upon Section 240(f) of the 1926 Act, broadened considerably *in order to afford adequate protection to the Government*. The section of the new bill provides that the Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them *in such manner as may be necessary in order to prevent evasion* (*by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'*) *and* in order to arrive at their true tax liability.
>
> "*The purpose* of the provisions of Section 45 is to *prevent the arbitrary shifting of gross income* and deductions among businesses owned or controlled by the same interests; to prevent the avoidance of taxes or the distortion of income by the shifting of profits from one business to another; to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income of the property and business of a controlled taxpayer. The statute vests in the Commissioner the discretionary power to make allocations of gross income and deductions of such businesses *when warranted* in order (1) to 'prevent evasion of taxes' or (2) 'purely to reflect the income' of any such businesses" (Emphasis supplied).

In the instant case there was no "evasion of taxes," neither by Mr. Smith, by the petitioner, nor by any stockholder of the petitioner. If the petitioner corporation had *never been formed,* Mr. Smith's taxes (and the taxes of the other stockholders, as well) would have been exactly in the amounts paid. There were no "fictitious sales," no "shifting of gross income," no "milking" of the petitioner corporation—or of any taxpayer.

II.

The United States Court of Appeals for the Sixth Circuit has, likewise, decided (or has, by entering its order without opinion, refused to decide) another, second, important question of Federal income tax law, which has not been but should be settled by the Supreme Court, that is as to whether the purchase of Coca-Cola syrup at $1.30 a gallon and its re-sale at $1.50 a gallon (which was done in 1941 and 1942—but not prior to 1941) resulted in a gain which can properly be held to be comprised in the definition of "personal holding company income" in Section 502 of the Internal Revenue Code.

III.

The Commissioner "allocated" to the petitioner a part of the income of Mr. Smith (for which he allowed Mr. Smith no off-setting deduction—R. 98), which the petitioner never earned or received (but which Mr. Smith did receive, and on which he paid all the income tax due thereon), under a claim of authority in Section 45, but which is not given him by such section. He *then claimed,* further, that this wholly fictitious income was personal holding company income, and that, since no personal holding company returns had been filed he was authorized to assess the personal holding company surtax, and penalty, on it, back

to the year 1934, in which year the personal holding company surtax was first imposed. And this, despite the fact that the Commissioner and his revenue agents had "all the facts before" them, from an examination of the petitioner's corporation income tax return for the year 1934, and from the returns filed year by year for each of the subsequent years to and including 1942; and despite the fact that the respondent having knowledge of the factual circumstances surrounding the petitioner's business through his agent's report for 1934, did not deem it necessary, for petitioner to file personal holding company returns." *Hugh Smith, Inc.*, 8 T. C. 660, 677.

IV.

The Commissioner has thus claimed authority (which he does not have) under Section 45 to "allocate" income (which did not exist) to the petitioner, for the sole purpose of taxing it as personal holding company income—when he and his agent alike, "having factual knowledge" of the petitioner's business and of the nature of its income, had considered and found it not to be personal holding company income during all the years the petitioner was in existence, 8 T. C. 660, 677.

Thus the order of the Sixth Circuit (affirming the decision of the Tax Court) leaves the law in a state of uncertainty, so much so that no taxpayer can ever be certain that he will not be called on to pay tax on income he never earned, or received, or even ever heard of; and the determination by this Court of this question of the limits, if any, to which the Commissioner may go under the guise of Sections 45 and 502 will settle the point of law, and remove the uncertainty, and make for uniformity of decisions in the future.

Wherefore, it is respectfully submitted that this petition for writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit should be granted.

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April ....., 1949.